

HELP ?

Japan: A setting sun?

Foreign Affairs; New York; Jul/Aug 2000; [Aurelia George Mulgan](#);

Volume: 79
Issue: 4
Start Page: 40-52
ISSN: 00157120
Subject Terms: [Reforms](#)
[Economic recovery](#)
[Political parties](#)
[Problems](#)

Classification Codes: **9179:** *Asia & the Pacific*
1120: *Economic policy & planning*
1210: *Politics & political behavior*

Geographic Names: Japan

Abstract:

The Asian financial crisis had a side benefit: prodding the Japanese government to fix its economy. But as the sense of urgency eased, so too did the momentum for change. The Liberal Democratic Party, never a true champion of reform, now blocks deregulation from every angle. Wasteful public spending has created little but debt. And the public's trust in its government is all but gone. Recovery would require Japan's politicians to give up the many benefits of the status quo, which they will not do without a fight. So Japan's reforms are stalled permanently. Its economy is, too.

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DEATH IN MIDSUMMER

TWO YEARS AGO, with an economy mired in recession and reeling from a full-blown financial crisis, Japan's elites realized that something had to give. They embraced a complete overhaul of the country's banking system and acknowledged the need for structural reform of the economy as a whole. Reform peaked in 1998, when Tokyo moved to rescue the financial system from imminent collapse, cut regulations, and revitalize industry.

Today Japan's recovery hangs in the balance. Just when the momentum for reform appeared unstoppable, the government's revival strategy began to lean too heavily on fiscal stimuli, pushing Japan into a spending rut. Economic growth will halt if Tokyo ignores the pressing need for reform. The government is backpedaling because the sense of urgency generated by the banking crisis has eased, because the economy is showing some signs of recovery, and because the upcoming general election is looming large in the minds of ruling Liberal Democratic Party (LDP) politicians. But the underlying problems remain, and shallow political opportunism is derailing reforms vital to Japan's future economic recovery.

JAPAN, INC.

BY SLOWING REFORM, Japan risks losing whatever economic momentum it has recently achieved. Self sustained growth seems frustratingly elusive. Vital indicators of economic health, such as personal consumption and business investment, remain weak. The decline in capital spending appears to have leveled off, but consumer spending continues to shrink. High-profile corporate failures are still causing mass layoffs. Many companies are trimming wages, bonuses, and work forces. Unemployment has

reached unprecedented highs, according to records dating back to the early 1950s—hardly a boost to consumer confidence. And consumer spending is unlikely to revive until the job outlook improves.

The only big spender in Japan today is the government, which launched nine mammoth stimulus packages, totaling \$1.2 trillion, between 1992 and 1999. The country's very modest return to growth in the first half of 1999 was fueled almost entirely by state largesse. Aggregate demand rose directly in line with increases in public-works spending. But when the effects of the pump-priming wore off in the third quarter of 1999, Japan slipped back into the recession that has plagued the country since 1993.

Japan's inflated budgets present another obstacle to economic recovery. Consumers and taxpayers fear that ultimately they, their children, and their grandchildren will have to finance the government's profligacy. Japan's aging society will severely strain social-welfare services and pensions, and many employees doubt whether they will ever see their promised benefits.

Furthermore, public confidence in Japan's government has been shattered. The bureaucracy's policy failures during the banking and economic crises cost it both credibility and trust. The bureaucracy's reputation was further tarnished by the various corruption scandals involving elite officials. As Japanese ministries try to halt the devolution of their powers to businesses and consumers by mounting a last-ditch defense against deregulation, the Japanese public grows increasingly frustrated.

On top of these bureaucratic failings is the chronic inability of Japanese politicians to come up with tough solutions when they are most needed. The ruling government coalition, led by the LDP, runs on stopgap proposals. Scant surprise, then, that it has turned decidedly against deregulation. Energies that should be directed toward developing coherent strategies for the nation's problems are dissipated in endless political power games. The misplaced zeal for irrelevant reforms, such as reducing the number of seats in the parliament's lower house, illustrates the politicians' misplaced priorities and collective political blindness. It is a blindness Japan can ill afford.

NEW HANDS, OLD HABITS

SEVERAL KEY recent appointments prove that the government's commitment to reform has lapsed. In the October 1999 reshuffle of cabinet and top party posts, Prime Minister Keizo Obuchi appointed Shizuka Kamei, a self-professed foe of reform, as chair of the LDP's Policy Research Council—making him the party's top policymaker. He has continued in this post under Prime Minister Yoshiro Mori. Obuchi also appointed Michio Ochi, a former Ministry of Finance (MOF) bureaucrat, to head the Financial Reconstruction Commission, which oversees banking reform. But despite Ochi's official support for restructuring, he attempted to mete out preferential treatment to small and midsize financial institutions, a move that ultimately led to his downfall. His successor, Sadakazu Tanigaki, will find it tough to convince a skeptical public that he will continue the commission's work in creating an impartial, transparent system of financial regulation.

In another antireform move, a group of LDP politicians decided to create a self-styled "Committee to Reconsider Deregulation" in November 1999, calling for revisions in government-sponsored deregulation programs. By March 2000, the committee had ballooned to around 165 members just under half of the LDP's total membership in the Diet, the Japanese parliament. All worried that deregulation could hurt small business—a traditional bailiwick of the LDP. In particular, committee members were responding to complaints from small retailers about increased competition from supermarkets and discount stores. The committee's sympathy is unsurprising. Beyond the metropolitan fringes, Japan is a land of farmers and small business operators, where LDP politicians find their strongest support.

The committee against deregulation is headed by Kabun Muto, who ironically also leads the LDP's Administrative Reform Promotion Committee-the party's main body responsible for deregulation. Muto's new ideology shows a stark change from earlier days when, as director-general of the Management and Coordination Agency under Prime Minister Ryutaro Hashimoto, Muto led the fight for deregulation. He now rejects the pro-market position he formerly espoused, arguing that too much deregulation "can be a bad thing." Other leading LDP executives, including Kamei, are also members of this committee, as is Education Minister Hirofumi Nakasone. Former LDP Secretary-General Yoshiro Mori resigned his membership only when he became prime minister in April 2000.

Although these sentiments may be dismissed as mere pre-election posturing, such a clear LDP stance against deregulation undermines the general climate of reform. Furthermore, electoral pressures are unlikely to ease even after the vote for the lower house of the Diet, scheduled to take place on June 25. In 2001, the LDP faces another election in the upper house, a body it does not control. Hence the party's backsliding away from reform is not likely to cease.

ARTFUL DODGES

IN ADDITION to these uninspiring political appointments, a succession of policy developments since late 1999 demonstrates that antireform forces within the government are gaining the upper hand. For example, last November the ruling coalition decided to amend a new public nursing-care insurance scheme, thereby lowering the financial burden on the elderly. Based on the new plan, premium payments by people over the age of 65 would be delayed for six months, with a plan to phase in payments over one year at just half the amount needed to meet program costs. The shortfall of \$9.5 billion would be covered by government borrowings, further delaying the creation of a financially viable scheme. The move was directly engineered by Kamei, who blocked the start of the new premium arrangements at the last minute.

One month later, the LDP put another reform on hold, this time affecting banks. In 1996, the government committed itself for five years to an unlimited guarantee on all deposits made at failed banks. In April 2001, the guarantee was due to be capped at \$95,000. But in a sudden policy reversal, full protection for depositors was extended for another year. Terminating the unlimited government guarantee on deposits was supposed to force banks, credit unions, and credit cooperatives to reform their management and heighten efficiency. But with the immediate pressures to improve their financial performance easing, the impetus for these institutions to reform themselves has diminished-thus slowing down the reorganization of the banking industry. Ochi reportedly engineered the delay to shield smaller credit unions and credit cooperatives and avoid the likely political fallout in local communities of any insolvencies. To many observers, the policy reversal had all the hallmarks of the old "convoy" system (*goso sendan*), the MoF's favorite technique for preventing bank failures: limiting competition and forcing stronger banks to bail out weaker ones.

Other recent policy shifts have added to the anticompetitive thrust of government measures. In another move, Ochi terminated the policy requiring regional banks that received public funds for recapitalization to raise their "capital adequacy ratios" to 8 percent-in other words, making them increase the amount of capital they set aside to cover loans in the event of borrowers' defaulting. Efforts to clean up the debts caused by failed housing finance companies (*jusen*) at the center of a mid-1990s scandal have also been throttled back.

Japan's prospects for reform are no better on the taxation front. The draft proposals for this year's tax reforms, prepared by the prime minister's advisory Tax Commission and the LDP's Tax System Research Committee, have put off the introduction of a consolidated corporate taxation system for at least one more year. Under this system, individual firms affiliated within the same holding company

would be treated as a single corporation for taxation purposes--so losses in one part of the group could be offset by profits in another. The idea was to promote corporate restructuring and boost the international competitiveness of Japanese companies. The LDP's tax panel recommended the introduction of the new system for Zoos. Based on this commitment, many companies pursued mergers or reorganized themselves. Postponing the new tax system leaves these companies in limbo and lessens the incentives for restructuring.

Who is blocking the tax reform? The blame lies squarely with the MoF and the LDP. The MoF has resisted the consolidated tax system for fear of reduced government revenues from corporate taxes. The LDP's opposition was based on fears about the effect of possible job losses on consumer demand.

Meanwhile, the LDP is poised to backtrack on some of the deregulation proposals of the government's regulatory reform committee, which presented the Obuchi administration with 234 changes that were due to take effect beginning in April 2000. Having successfully torpedoed the attempt to deregulate the taxi industry, the LDP's committee against deregulation now has its sights set on blocking the proposed deregulation of licensing requirements for liquor retailers.

Other reforms may also disappoint. The much-heralded amendment to the Large-Scale Retail Stores Law--which would enable supermarkets and other big retail outlets to set up in neighborhoods dominated by mom-and-pop stores--is much less of an unequivocal victory for retail market liberalization than was originally thought. The amendment still allows local communities to veto the introduction of large-scale retailers. Only the grounds for objection have changed: vetoers must now cite "potential threats to the living environment."

HEY, BIG SPENDER

EVEN IF the Japanese economy achieves the modest growth forecasted for 2000, the government will still need to repay the massive amounts it borrowed for the past string of pump-priming spending packages. But for the time being, any thought of reducing the mountain of public debt has been abandoned. Budgetary stimulus has become the principal means of spurring economic recovery.

Until recently, the chief constraint on government spending was the MoF and its strict advocacy of fiscal prudence and debt reduction. The budgetary brakes came off, however, when this stance was mistakenly seen as choking economic recovery in 1997-98. So from July 1998, the Obuchi administration relentlessly focused on public-works projects. In November 1998, for instance, it finalized a \$206 billion emergency economic package, the biggest stimulus in the nation's history. Around the same time, it prepared a 1999 budget that contained the biggest annual spending increase on record--a rise of 5.4 percent to \$771 billion. Two more supplementary budgets followed in 1999. Not to be outdone, the 2000 budget features a record \$810 billion in outlays. On the revenue side, 38 percent of budget income, or \$310 billion, comes from deficit-financing bonds.

Obuchi, who called himself "the world's largest debtor," issued more government bonds than any other prime minister since 1965--the year in which bonds were first released. The 2000 budget brought his total up to \$800 billion, far surpassing the corresponding figures for each of his 16 predecessors. Outstanding long-term debt, which includes both national and local government debts, has inflated to \$6 trillion, or 1.3 times Japan's GDP--a per capita debt of about \$48,000.

The official justification for such indebtedness is that economic recovery depends on massive injections of money. But these enormous expenditures also conveniently serve the pork-barrel objectives of the LDP, keeping thousands of small construction companies afloat and their more than six million

employees engaged in government-funded public works around the country. The 2000 budget, for instance, is dominated by traditional construction projects, such as extensions of the shinkansen bullet train to less-populated areas of Tohoku and Kyushu. The publicworks portion of the overall budget is too high, and the shares within it of traditional public-works categories, such as agricultural land improvement and road construction, are too fixed. Such projects entail huge investments but contribute nothing to economic efficiency. Rather, they typify the wasteful, unproductive, and environmentally questionable nature of much of Japan's public infrastructure spending.

One symbol of this fiscal rigidity is Japan's constant emphasis on road-building. Japan has a higher ratio of paved to unpaved roads than in the United States, yet road construction invariably consumes almost 30 percent of annual public-works outlays. Although the Obuchi administration created new categories of public-works expenditures, such as quality-of life programs, information-technology and telecommunications projects, and improved distribution networks all designed to contribute to economic revival—these new categories accounted for less than 6 percent of proposed budgetary allocations. And the innovative gloss of so-called millennium projects scheduled for 2000-2001 cannot hide the fact that they have served as excuses for ministries to bid for new money by aligning their requests with new expenditure goals.

The problem with all this is that the government's main weapon for reviving the economy—fiscal stimulus to spur domestic demand—entails substantial risks down the road. The government's increasingly lavish spending spree, financed by debt, courts future fiscal disaster and other detrimental developments, such as rising long-term interest rates. Deficit spending is not accompanied by reforms that promote greater efficiency and competitiveness. Nothing is in place to help sustain growth when the effects of the fiscal stimulus wear off. But Japan's fragile economy presents a golden opportunity for the government to discard its conventional spending habits and adopt new, more effective ones. Spending on the right projects and sectors of the economy will yield an economic renewal impossible under the current spending patterns.

Furthermore, the government must resume its deregulation agenda. Two-thirds of 254 Japanese economists at a gathering in late 1999 chose deregulation as the most important means for bringing about an economic recovery. Deregulation will encourage business start-ups, breed new industries, and entice new market entrants into existing sectors. The results will be a more competitive business environment, greater corporate efficiency, lower prices for consumers, new jobs, and increased consumer spending. These moves should be complemented by government spending on projects that boost productivity, as well as by stopgap measures such as job retraining and expanded financial aid for job placement agencies.

SIX DEGREES OF SEPARATION

UNDERLYING the COUNTRY'S economic difficulties lies the fundamental obstacle to reform: Japan's political and administrative structure is not equipped to embrace radical change. Existing government systems are preventing real reforms from taking place. In this respect, Japan is facing a crisis of governance. Not only do politicians pander to special interests, but vested interests are institutionalized in the very structures of governance.

Within the LDP, vested interests are embedded in informal policy cliques (*zoku*) that dominate the party's policymaking committees and government ministries. These cliques cluster in specific policy fields such as construction, the postal system, telecommunications, small and medium-sized enterprises, transportation, welfare, and agriculture and forestry. Characteristically, the special interests that form the major building blocks of the LDP's support structure—such as small retail businesses, transportation, construction, wholesaling, and distribution, as well as farmers and postmasters—oppose deregulation and

economic liberalization. The zoku act as their most powerful voice within the party, in exchange for votes and funds. The zokus' importance as party fundraisers and vote-gatherers ensures that their members rise up the LnP hierarchy and gain executive positions both in the party and in government-where special interests can be championed at the highest levels. Zoku power helps explain the rigidity of public-works spending across the standard categories of expenditure-because zoku politicians make sure the MoF's Budget Bureau does not interfere.

Vested interests are also entrenched in the Diet, whose members maintain their own personal support groups (koenkai), which serve as grassroots campaign machines. Interest-group leaders and local business owners are important members of the koenkai. But these support groups impose their own obligations on Diet members, notably patronage. Local constituents seek favors from their representatives in Tokyo, who seek to grant them by interceding with administrative authorities. Politicians pressure government officials' decisions about the granting of licenses and permits for businesses, the maintenance of protectionist measures, the allocation of subsidies for public-works projects, and the awarding of public-works contracts. When unpopular decisions are being considered, politicians flood informal Diet members' committees to signal their support for local interests. Koenkai members respond with financial and campaign support and by delivering their votes and those of allied interest groups and companies.

Strikingly, personal support groups can be bequeathed to political successors as fully functioning constituency machines-testifying to the strength of these patronage connections and the consequent resilience of koenkai. The vested interests bound up in the koenkai get handed down through generations; second- and third-generation politicians inherit their fathers', fathers-in-law's, and grandfathers' koenkai. In the 1996 general election of the lower house of the Diet, 122 sons, daughters, sons-in-law, and grandsons of former Diet members won seats in the 500-person house. More important, 51 percent of the ruling LDp came from second- and third-generation Diet members.

For bureaucrats, vested interests are institutionalized in the practice of amakudari-"descending from heaven"-whereby bureaucrats retire from government ministries and agencies into executive posts in semipublic organizations and onto the boards of banks, industry associations, and big corporations. Systems of regulation require that corporations maintain good connections with regulators; hence the need to give posts to ex-officials who can provide access to the ministry. Apart from offering bureaucrats lucrative postretirement positions, companies operating within regulatory nets also provide all kinds of "private goods"winning and dining, golf club memberships, interest-free loans, domestic and overseas travel, and bribes. Regulations thus sow the seeds of corruption as businesses try to gain the favors of regulators and bureaucrats sell their favors for personal gain. Shusei Tanaka, a former leader of the Sakigake Party, recently accused MoF bureaucrats of not wanting to relinquish their oversight of financial risk management because this role provided them with financial institutions to join after leaving government service.

Critical to the maintenance of regulatory systems are the thousands of "semipublic" organizations that act as auxiliary government agencies. These entities take the form of public corporations, "approved" corporations, and "public-interest" corporations attached to individual ministries and agencies. Their fundamental purpose is to extend the regulatory reach of the mainstream bureaucracy into industry sectors and provide high-level jobs to retired bureaucrats. They consume vast government subsidies, as well as loans from the Fiscal Investment Loan Program-the massive public-infrastructure pork barrel financed largely by the postal savings system. Despite the enormous costs and staggering inefficiencies of these semipublic bodies, Japan's deregulatory and administrative reform programs have left them almost untouched.

Vested interests have become woven into the very administrative and political fabric of Japan. Not

surprisingly, relying on politicians and bureaucrats to change this fabric has yielded few results. The ideas and impetus for change must therefore come from nontraditional sources. In an attempt to circumvent LDP politicians and the bureaucracy, Japan's prime ministers have established several "special advisory councils" on deregulation and administrative reform dominated by representatives from business and academia. This new approach-or "council politics"-got its biggest push from Prime Minister Yasuhiro Nakasone and has been continued by most of his successors. But proposals for change can be exploited to make prime ministers look good and create the illusion of reform, even though they amount to little more than good intentions. Even in the best scenario, in which Japanese prime ministers seek bold reforms prompted by advisory council recommendations, these bodies and their recommendations can still be influenced and even sabotaged by bureaucrats. Government officials exercise practical controls over council processes through the information they make available to council members, the guidance they provide on drafting council reports, and their influence over membership selection. Ministries also have their own representatives in the advisory councils (both current and retired officials) and strategically infiltrate the coordinating agencies of the government's deregulation and administrative reform programs-the Management and Coordination Agency and the Economic Planning Agency.

Finally, bureaucrats have managed to penetrate the administrative infrastructure surrounding the prime minister: the prime minister's office, the cabinet secretariat, and the prime minister's official residence. These executive agencies are all colonized by mainstream bureaucrats-particularly from the MoF and the Ministry of International Trade and Industry whose primary loyalties are to their original ministries. As part of the prime minister's inner circle, the bureaucrats are ideally placed to subvert all aspects of reform and can monitor the transmission of information between the ministries and the prime minister. Their input into the drafting of laws from advisory-council recommendations also lets them shape reform legislation itself.

DECONSTRUCTING MEIJI

DESPITE THE FACT that the Japanese economy has repeatedly shown that old methods and policies do not work, the push for reform has been vetoed by bureaucrats and LDP politicians. The modest injection of dynamism into the economy effected by corporate restructuring, the information-technology boom, the explosion in e-commerce, and the dissolution of traditional keiretsu corporate groups-legacies of the zaibatsu conglomerates that were broken up after World War II-is not enough to offset the drag of vested interests and myopic, self serving bureaucrats and politicians.

Most Japanese harbor grave doubts about whether existing institutions-with their poor record-can bring about much-needed reforms. This pessimism is holding back consumer spending and undermining Japan's shaky economic recovery. The structure of vested interests, therefore, needs to be dismantled. But this would require the major beneficiaries to voluntarily give up their concessionary rights. Unfortunately, the improbability of this only confirms today's deep pessimism about Japan's future. As policy developments in recent months have demonstrated, the will to reform is easily dissipated.

Japan is on the brink of structural decline. The signs are already present: Japan's national income in 1998 marked the first yearly decline since the end of World War II. In 1999, the country's per capita GnP slumped to seventh worldwide, behind Switzerland, the Scandinavian countries, and the United States-a major fall from 1993 and 1994, when Japan topped the list. Furthermore, Japan's trade surplus shrank in 1999 for the first time in three years, dropping 11.7 percent to \$118 billion.

With dwindling economic fortunes will come a decline in Japan's international influence. A government saddled with massive debt has less for expensive defense equipment, foreign aid, donations to international organizations, and "host nation" support-the money that effectively subsidizes the

American military presence in Japan. All are essential elements of Japan's international status and influence. In the 2000 budget, foreign aid was cut, and Japan's contribution to U.S. military expenses ended up smaller than the Defense Agency's request for the first time since 1978.

But Japan's reform is also contingent on opening up the country's economy and businesses to foreign products and services, as well as to foreign investors, takeovers, and mergers. This internationalization should also include an opening of Japanese society and culture to foreigners. Immigration entails not just the entry of temporary migrant labor to fill difficult and dangerous jobs, but the inflow of migrants who stay and become part of the social, economic, and political fabric of the nation. Immigration will also import demand and innovation into the Japanese economy. In its absence, the domestic market will shrink inexorably, the government's revenue base will contract, and an aging society will demand more from social welfare services.

Many of these pessimistic views are shared by Japanese opinion leaders in business and academia. They have also been endorsed by the prime minister's advisory council on "Japan's Vision for the 21st Century," which presented its report in January 2000. The council wrote, "We share a sense of urgency, an anxiety that Japan might go into decline if things stay unchanged." It goes on to exhort the Japanese people to muster the courage to face the challenges ahead. The council offered many radical, unprecedented proposals urging Japan to shrink the government by accelerating deregulation, curb pork-barrel spending, and give the Japanese citizenry a direct vote in electing the prime minister, thus creating a new power center to check the bureaucracy and special-interest politicians.

On receiving the report, Obuchi said that Japan was facing a "third revolution" comparable to the Meiji Restoration and the American-imposed Occupation reforms. But as the Asahi Evening News points out, the Meiji Restoration destroyed the old ruling class of 1.5 million samurai, and the early postwar reforms purged 200,000 wartime leaders from public office. In both cases, the result was a fundamental transformation of the structure of governance by a powerful new force. It remains to be seen whether the current Japanese system can generate a similarly radical response.

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